

Internal Revenue Service
memorandum

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to: Joseph J. Newman, Case Manager
Group 1511

from: Newark District Office

subject: Charles P. Besecky, Senior Technical Reviewer
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CC:INTL:Br4

[REDACTED] EIN [REDACTED]
Taxyears Ending [REDACTED] [REDACTED] [REDACTED]

Section 1248 and Interim E&P Adjustments Under Pre-TEFRA §334(b)(2)- Informal
Counsel Assistance (ICA) (INTL-0115-91)

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ISSUE

Whether a taxpayer electing retroactive application of §959(e) of the Code for amounts previously included under §1248 is entitled to include §1248 gain in computation of "interim earnings and profits" under §1.334-1(c)(4)(v)(a)(2) of the Income Tax Regulations (regulations).

BRIEF ANSWER

Application of both §959(e) of the Code and §1.334-1(c)(4)(v) of the regulations results in two basis increases for the same §1248 dividend. Section 1.334-1(c)(4)(vi)(c)(1) permits us to disregard the §1248(f) sale of stock for purposes of basis adjustments under §334(b)(2), since to do otherwise results in a distortion. Alternatively, the §959(e) election could be ignored under a "duty of consistency" theory. However, it is the policy of this office is to apply §959(e) where technically applicable and where there are other avenues to the proper tax result. Because the statute of limitations does not bar adjustments in the earlier year, adjustments should be made under §334(b)(2) rather than §959(e).

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FACTS

[REDACTED] (*Purchaser*) acquired the stock of [REDACTED] (*Target*) on [REDACTED]. At the time of the acquisition *Target* owned the stock of several controlled foreign corporations (*Target-CFCs*). *Purchaser* made a section 338(g) election for *Target's* acquisition under §224(d)(2) of TEFRA 1982 as amended by §306 of the Technical Corrections Acts of 1982 ("transitional rule election"). *Target* selected [REDACTED] as the deemed sale date under §5f.338-2(f)(3) (now §1.338-2T(f)(3)) of the regulations. This created an "interim period" beginning on the acquisition date ([REDACTED]) and ending with the deemed sales date ([REDACTED]).

The effect of the §338(g) election is to treat *Target* as having sold all of its assets (including the stock of the *Target-CFCs*) to a new corporation in a sale to which §337 (as in effect prior to TRA 1986, hereinafter "prior §337") applies. Pursuant to prior §337, *Target* generally recognized no gain or loss on the sale of its assets. However, items such as recapture of depreciation under §§1245 and 1250 were required to be recognized. Additionally, pursuant to §1248(f)(1), as then in effect, §1248(a) applied to the deemed sale of the *Target-CFC's* stock.

Purchaser filed a deemed sales return for *Target* and the *Target-CFCs* that reflected a §1248 gain of \$[REDACTED] with §902 credits of \$[REDACTED] and the resulting §78 gross-up of \$[REDACTED]. It is agreed that these are correct amounts. *Purchaser* increased its basis in *Target* stock by adding *Target's* earnings and profits for the interim period, including therein the §1248 gain and §78 gross-up included in *Target's* income for that period. *Purchaser* then computed the basis of the *Target's* assets (including the *Target-CFC* stock) by allocating its basis in *Target's* stock to *Target's* assets. The propriety of the addition of the §1248 gain and §78 gross-up to the interim earnings and profits is at issue.

After the enactment of §959(e) in 1984, *Purchaser* elected to apply retroactively that section to the §1248(f) dividend. The effect of this election was to treat the §1248(f) dividend as if included in the gross income of *Target* under §951(a)(1)(A). Pursuant to §961(a), *Target* increased its basis in each of the *Target-CFCs'* stock, to the extent of the §1248 dividend from each. This basis increase is based on the same earnings which increased the basis of the *Target-CFC* stock (and accordingly *Target's* assets including the *Target-CFCs* stock) under §1.334-1(c)(4)(v)(a)(2).

APPLICABLE LAW

Statute and Regulations

Section 338 was added to the Code by TEFRA 1982 (as amended by the Technical Corrections Act of 1982) and applies to acquisitions of stock for which the acquisition date occurred after August 31, 1982. Section 1.338-2T(a)(1) allows a purchaser to make a transitional rule election for corporations for which the acquisition date occurs after August 31, 1980, and before September 1, 1982. The acquisition date of [REDACTED] falls within the parameters of the transitional rule election.

Where a transitional rule election is made, §338 (as in effect on July 17, 1984) applies to the acquisition with certain exceptions as set forth in §1.338-2T(e). One exception relates to determining the basis of target's assets after the §338(a) deemed purchase. Instead of applying §338(b) and the regulations thereunder, §1.338-2T(e)(3)(i) provides that a rule similar to the last sentence of §334(b)(2) (as in effect on August 31, 1982) applies to determine the bases of the target's assets.

Like its successor §338, §334(b)(2)¹, attempted to give a purchaser of stock an aggregate tax basis in the target corporation's assets equal to the cost of the target's stock. Unlike §338, §334(b)(2) required liquidation of the subsidiary to achieve the basis step-up. Section 334(b)(2) provided that the basis of the target's assets received in liquidation would be equal to the adjusted basis of the stock with respect to which the liquidating distribution was made. The last sentence of §334(b)(2) further provided:

. . . under regulations prescribed by the Secretary, proper adjustment in the adjusted basis of any stock shall be made . . . for any money received, for any liabilities assumed or subject to which the property was received, and for other items.

Section 1.334-1(c)(4)(v) contains these basis adjustments, made only for determining the basis of a target's assets. Section 1.334-1(c)(4)(v)(a)(2) provides that the adjusted basis of the target's stock shall be increased by the portion of the target's earnings and profits of the period beginning on the date of purchase and ending upon the date of the last distribution in liquidation. Under this section of the regulations, *Purchaser* included the §1248 gain and §78 gross-up in *Target's* earnings and profits. *Purchaser* then added this amount to its cost basis in the *Target* stock and allocated this amount to *Target's* assets, including the *Target-CFCs'* stock².

¹ All references to §334(b)(2) are to that section as in effect before August 31, 1982.

² This memorandum does not concede that §1248 gain is a proper addition to interim earnings and profits. To the contrary, we believe that §1248 gain should not be included in the interim earnings and profits adjustments of §1.334-1(c)(4)(v)(a)(2). Although the Service has repeatedly taken the position that §1245 and 1250 depreciation recapture income should not be included in the §1.334-1(c)(4)(v)(a)(2) adjustments, this position has never been

Before §959(e) of the Code was enacted in 1984, it was unclear what effect a §1248(f) deemed dividend had on the earnings and profits of the controlled foreign corporation (CFC) considered to make the distribution. It was also unclear what basis adjustments, if any, the recipient U.S. shareholder of a §1248(f) dividend could make to the stock in the distributing CFC or what foreign tax credits the U.S. shareholder could claim in connection with the deemed distribution. If the US shareholder included income on the deemed §1248(f) dividend also included income on the later receipt of an actual distribution (supported by the same earnings and profits as the §1248(f) dividend), then the US shareholder arguably could claim a foreign tax credit twice--on the §1248(f) dividend and on the actual distribution--even though the CFC paid foreign taxes on the same earnings only once.

To resolve these problems, Congress enacted §959(e) as part of the Deficit Reduction Act of 1984³. The Act allowed taxpayers to elect to have §959(e) apply retroactively to transactions to which subsection (a) or (f) of §1248 applies occurring after October 9, 1975⁴. *Purchaser*, in this case made the election in a timely manner.

For §1248 dividends, §959(e) provides that any amount included in the gross income of any person as a §1248 dividend will be treated for purposes of §959(a) as an amount included in the gross income of such person under §951(a)(1)(A). Section 961 provides for adjustments of basis for income included under §951(a).

Under §961(a), a US shareholder increases its basis in the CFC stock by the amount required to be included in its gross income under §951(a). Under §961(b), a US shareholder reduces its stock in the CFC stock by amounts received that were excluded from gross income under §959(a).

successfully advanced in litigation (*see R.M. Smith v. Commissioner*, 69 T.C. 317 (1977) *aff'd.* on another issue 591 F.2d 248 (3d Cir. 1979)). Our most recent defeats were in *Tele-Communications, Inc., et al v. Commissioner*, T.C. Memo 1991-82, Tax Ct. Dkt. No. 3172-90 (Feb. 29, 1991) and *Philip Morris, Inc., et al. v. Commissioner*, 96 T.C. No. 23, Tax Ct. Dkt. No. 28604-82 (April 12, 1991) both of which upheld the earlier decision in *Smith* that the entire amount of depreciation recapture is correctly included in the interim earnings and profits adjustments. The *Philip Morris* case was the first case to address the appropriateness of inclusion of §1248 dividends in the interim adjustments. The court recognized the issue as one of first impression and held, without discussion, that the analysis of *Smith* was equally applicable to §1248(f) dividends. The briefs filed by the Service in *Philip Morris* do not address the §1248 issue. (b)(5)(AWP), (b)(5)(AC), (b)(5)(DP)

³ Section 133(b)(1) of P.L. 98-369, 1884-3 (Vol. 1) C.B. 175, 176.

⁴ Section 131(d)(3) of P.L. 98-369.

As noted above, *Purchaser* elected retroactive application of §959(e). The *Target-CFCs* set up previously taxed income (pti) accounts for prior §1248 dividends deemed paid, including the §1248(f) dividend triggered by the §338 election for *Target*. Pursuant to §961(a), *Target* increased its basis in CFC stock to the extent of the §1248 dividend from each. These basis increases were based on the same earnings as the earlier basis adjustments arising under §1.334-1(c)(4)(v)(a)(2).

Section 1.334-1(c)(4)(v)(a) provides that the basis of the target's stock in the hands of the purchaser is increased by (1) unsecured liabilities assumed by the purchaser, and (2) *the target's earnings and profits (less distributions therefrom) of the interim period*. It further provides that the purchaser's basis in the target stock is decreased by i) the amount of cash or cash equivalents received; and ii) any deficit in earnings and profits of the interim period. These adjustments are intended to conform a delayed liquidation (resulting in an interim period) to an immediate liquidation. However, where transactions take place during the interim period that result in an inappropriate adjustment to the basis of the stock of the target, the transaction may be ignored.

Section 1.334-1(c)(4)(vi)(c)(1) provides that to prevent the distortion in the adjusted basis of the stock:

Transactions (including distributions, liquidations, and reorganizations) involving a corporation the affairs of which the subsidiary [target] controls at any time after the date of purchase through ownership of stock (whether or not the subsidiary owns a majority of the stock of such corporation) may be disregarded in whole or in part.

On the basis of the wording, it can be argued that the gain recognized under §1248(f) should be ignored in computing basis. To give basis for the §1248(f) gain would distort the adjusted basis through two basis increases (the second increase due to the later §959(e) election). Although the wording of §1.334-1(c)(4)(vi) is awkward, we believe that the Service should take the position that it applies and that the basis increase for the §1248(f) gain is eliminated in the computation under §334(b)(2).

Based on the wording of §1.334-1(c)(4)(vi)(c)(1), we advise you to take the position that, for purposes of determining *Target's* basis in its assets after its purchase, the deemed sale of the *Target-CFCs'* stock should be disregarded. The sale should not otherwise be disregarded, for example, for purposes of determining the amount of §1248 gain.

We recognize that the entire amount of §1248 gain triggered by the deemed sale of assets upon the §338 election may not have been allocated to *Target-CFC stock*. We assume that the allocation was done on a fair market value basis. Thus, the amount of §1248 gain allocated to

the *Target-CFC* stock will depend on the relative value of the *Target-CFC* stock compared to *Target's* other assets. We suggest that you disallow in whole the §1248 gain inclusion in the §1.334-1(c)(4)(v)(a)(2) adjustments.

Alternative Argument

An argument further supporting our position is the "duty of consistency" argument. Under this theory, *Purchaser* was not entitled to make the §959(e) election for *Target-CFCs* whose basis was earlier increased under §334(b)(2) because *Purchaser* had a duty to consistently treat related items⁵. The duty of consistency applies if:

- (1) the taxpayer has made a representation or reported an item for tax purposes in one year,
- (2) the Commissioner has acquiesced in or relied on that fact for that year, and
- (3) the taxpayer desires to change the representation, previously made in a later year after the statute of limitations bars adjustment for the initial tax year.⁶

Thus, if the statute of limitations was past for the initial tax year (the year in which the §334(b)(2) adjustments were made), we could argue that the §959(e) adjustment should be disallowed since both adjustments are based on the same earnings and transaction. The duty of consistency holds a taxpayer to the consequences of the initial treatment, though inaccurate, *when a correction throughout is impossible* (emphasis added)⁷. In this case a correction is not impossible since the initial tax year is open and at issue, accordingly the adjustment should be made for the earlier year.

⁵ Taxpayers are "held to a duty of consistency in their tax treatment of related items." (See *Unvert v. Commissioner*, 72 T.C. 807 (1979), 656 F.2d 483 (9th Cir. 1981), cert. den'd 456 U.S. 961 (1982).

⁶ See *Unvert* at 814.

⁷ *Johnson v. Commissioner*, 162 F.2d 844, 846 (5th Cir. 1947).